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SUBJECT: RESPONSE: IMPACT OF RISING FOOD/COMMODITY PRICES- ETHIOPIA

Ref: State 39410

11. SUMMARY: Ethiopia is witnessing significant food inflation. However, this inflation appears to be caused primarily by internal forces rather than global market forces. An expected poor upcoming Belg season harvest is likely to exacerbate further the already-tenuous food situation. The U.S. Agency for International Development (USAID) and other donors are providing significant programmed food assistance with an anticipated need for more this year due to drought and rising prices. END SUMMARY.

12. DEMAND: Ethiopia's essential foods are cereals (maize, wheat, sorghum, and the indigenous teff), oilseeds, and pulses (lentils, chickpeas and horse beans). Prices of key commodities have risen significantly, with food inflation in excess of 70% in the last three years. Food inflation rose by 39.4%, on an annualized basis, in March alone. In commercial terms, Ethiopia is not a significant importer or exporter of cereals. Its dependence on domestic food production and humanitarian food aid essentially insulate it from world food price fluctuations. The country continues to suffer from food deficits, and a significant amount of wheat is imported each year mostly in the form of food aid with some small commercial purchases. The Government of Ethiopia (GoE) has banned the export of cereals, but the impact on prices from that ban is minimal as the level of exports was small. The GoE has also banned the local purchase of food for food aid programs. Ethiopia is a net exporter of oilseeds, mainly sesame seed and niger. While oilseeds themselves are not imported, the country's local edible oil industry is moribund due to the high price of inputs and large amounts of edible oils, especially palm oil, that are imported. The country exports certain legumes, particularly white beans.

13. Maize is the main cereal consumed by rural populations. Teff is primarily consumed by urban dwellers with higher incomes. There is evidence of an overall shift to wheat from teff and maize with price increases in the latter two coupled with growing urbanization. Recently, increased demand for milled flour and bread along with better information available to farmers and fears of a poor upcoming harvest has shifted the price of wheat even higher. The rising cost of wheat is having a particular impact on the urban poor.

14. A number of factors have increased market demand. Double-digit GDP growth and aid programs including the productive safety net program (PSNP), which provides food and/or cash assistance to the most vulnerable population, have increased rural incomes from 592 birr per capita in 2004/5 to 691 birr per capita in 2006/7. The National Bank of Ethiopia suggests that rural consumption patterns now more closely resemble urban consumption, thus boosting demand and raising prices. Rapid population growth (2.7% per year) puts additional stress on the market from the demand side.

15. SUPPLY: Agricultural production in Ethiopia can be described as "sticky" and slow in its ability to respond to market forces. According to an economic analysis (Bellmon Analysis) performed in early 2008, cereals production has increased 43% in the last three years due largely to good rains and an expansion of the area under cultivation. Consumption of pulses has risen over the last four years partly due to substitution away from meat and partly due to increased purchasing power; production has risen to address this.

In the Bellmon Analysis, farmers reported increased cultivation of grains and pulses, but the associated field visits did not find evidence of the increase. In general, Ethiopian agriculture is based on small-holdings and obtaining additional land - controlled and allocated by the state - to respond to price increases is very difficult. Additionally, state control of inputs (seed and fertilizer) along with inefficient distribution, hampers the ability to respond.

¶6. The Prime Minister of Ethiopia has cited concern that farmers and merchants are hoarding staples in order to "enrich themselves illegally." A Bellmon Analysis update performed in April 2008 found that farmers were holding, on average, the equivalent of three months household consumption for a family of five. As rural incomes rise, farmers are no longer dependent on selling upon harvest, when prices are at their lowest, and instead are able to delay sales to take advantage of higher prices later in the season. Farmers indicated that they do plan to sell much of this stockpile. The update also discovered that, rather than hoarding, traders were actually unable to obtain the stocks of grain they anticipated. The traders attributed this to the rise of independent Isuzu truck drivers who are scouring the countryside for 5-10 metric ton loads of grains and selling them to individual contacts at prices set via mobile phone.

¶7. The expansion of mobile telephone coverage now allows rural farmers and traders greater access to market information. Thus, the traditional pattern of a "fire sale" immediately after harvest is further being replaced by selling commodities over time in response to market fluctuations. While this does have the effect of raising overall prices, it must be viewed as a positive sign of market development in the agricultural sector and a reduction on rural

ADDIS ABAB 00001228 002 OF 003

poverty. Ethiopia has inaugurated a commodities exchange, but due to concerns over speculation the exchange will not allow the sale of futures.

¶8. POLITICAL IMPACT: To date, there have been no public protests or violence over food costs, although one small demonstration regarding overall inflation was reported. The ruling party handily won the recently-completed local elections and seems to have a firm grasp on power. There have been clashes between the Guji Oromo and Sidama clans which have been attributed to competition for land for grazing and growing khat, indicating stress in these populations. There are several large biofuel projects underway, but to date they do not seem to be taking place on land previously used for growing food crops, thus public reaction is generally positive.

¶9. ECONOMIC IMPACT: The Bellmon Analysis concluded, and other experts concur, that Ethiopia is relatively insulated from global commodity prices (apart from the associated impacts of global oil prices captured in transportation costs), and the fluctuations are due to internal macroeconomic factors. When cereal price movements are compared against the non-cereal index, it shows that most of the food price increase is associated with overall inflation and not a result of supply and demand. Thus, food is following an overall (and recent) rise in inflation. For February and March 2008, data shows that cereal prices are beginning to rise faster than the overall rate of inflation. Reasons cited for the increased overall inflation include an expanded money supply, the increased purchasing power and market knowledge of the rural population, and the increase in import prices (especially petroleum). IMF ResRep Arnim Schwidrowski argues that the additional rate of food inflation may be attributable to a particularly high income elasticity of demand for food in Ethiopia (i.e. as incomes rise, the people buy more and better quality food). Global petroleum prices are also affecting Ethiopian food prices by driving up the cost of fertilizer.

¶10. The food price impact is greatest on the urban and rural poor - those who cannot produce food for themselves and must purchase it. Despite overall GDP growth and the rise in rural incomes, these groups are increasingly unable to meet their nutritional needs at rising prices. An estimated 9 million people are currently in need of food assistance. There have been press reports relating the decrease in the ability of even middle-class Ethiopians to keep up

with rising prices. Sources have been quoted as saying they have reduced their meals to two per day, have stopped purchasing meat, and have cut back on the amounts of pulses and vegetables they consume.

¶11. ENVIRONMENTAL IMPACT: There is no current information on the environmental impact of rising food prices.

¶12. GOVERNMENT POLICY RESPONSE: The GoE has responded to food inflation by subsidizing wheat and cooking oil to the urban poor, banning grain exports, eliminating the value added tax on grains, and instituting a task force to root out "illegal traders" who speculate in commodities. Cereals traders are now required to post prices clearly. All land is owned by the state. There have been no verified reports of farmland being redistributed or any food-related industries being nationalized. The National Bank of Ethiopia is struggling to control overall inflation that has soared to nearly 30% on an annualized basis.

¶13. IMPACT ON POST PROGRAMS: Both local and global inflation have a major impact on USAID's projects in Ethiopia, especially the food aid program. With a serious drought this year, the GoE is not allowing local purchase, so that donors are buying food regionally and internationally. However, given that inflation is global, cash donations procure less food. Since USAID ships food aid in kind from the U.S., global inflation definitely impacts on how much can be procured. USAID's Office of Food for Peace reports that commodity prices have increased 41% in FY08 and that ocean freight rates have increased by 26%. Ethiopia's food aid program is the second largest in the world, with \$196 million contributed so far in FY08. Overall global inflation will have an impact on the amount of food that can be purchased and shipped in upcoming periods. USAID recently received \$200 million in relief funds from the Emerson Trust and is hoping for additional supplemental allocations to meet worldwide emergency food needs. Ethiopia's food inflation has also significantly eroded the purchasing power of Post's Locally Engaged Staff (LES). While the Department has approved an 8.5% cost of living salary increase for our LES colleagues, this has done little to counter the 70% food inflation rate experienced since 2004.

¶14. POLICY PROPOSALS: Because commodity prices in Ethiopia are rising due to indigenous factors, primarily overall inflation, the GoE needs to undertake measures to curb rapidly rising inflation. Indicators point to excess liquidity in the market, onerous foreign exchange regimes and the heavy state role in the agricultural supply system as threats to economic stability. In addition to working to stabilize the overall economy, the GoE should continue its efforts in conjunction with USAID and other donors to increase the capacity of Ethiopian farmers to produce more and better crops. Further,

ADDIS ABAB 00001228 003 OF 003

reforms such as encouraging private sector participation in the supply of inputs (fertilizer and seed) and land tenure reform to allow farmers to leverage their holdings to improve their land and crops could alleviate supply pressure and rigid supply response.

¶15. COMMENT: While food prices in Ethiopia are soaring, they are not moving upward primarily due to global shocks. Instead, Ethiopia's overall skyrocketing inflation coupled with increased demand and relatively stagnant supply are creating the country's own "perfect storm" for rising prices. While rising global prices will have an effect on the ability of the U.S. and other donors to provide food aid in the quantities needed, Ethiopia's homegrown crisis must be addressed internally. END COMMENT.

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